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INVESTMENT MANAGEMENT

SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Isn't the Stock Market a Forward Predictor?

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | JULY 2019

1. In my opinion, the stock market is a forward predictor, and Fed policy is a coincident indicator.

Consider:

- a. In Q4 2018, the stock market got hit very hard but Fed Chair Powell told us the US economy was just fine.
- b. Today the US stock market is hitting new highs and Fed Chair Powell is telling us the US economy is weakening.

The stock market told us in December that there were going to be problems with the US economy in 2019. Now Powell is confirming that.

With the stock market hitting new highs, what is this telling us about the economy in the future?

I think the market is telling us that the US economy is going to be stronger in the future. Not weaker.

I suspect that we will be hearing from Fed Chair Powell later this year that the economy is on better footing than it was in the first half.

2. The stock market is hitting new highs but the level of bullishness is very low. \$153 billion has flowed out of global equity funds year-to-date (the second worst on record) despite the best start to the year since 1997.¹ The week leading up to July 4th experienced \$28 billion of net outflows, one of the worst weeks in the past 12 years.² And yet the stock market is around 3,000?

Someone or something is wrong here.

Will the market turn out to be right and investors will have to chase back as the market continues to grind higher? Or is the bearishness accurate and the market will head lower?

In essence, should we respect the market or should we respect consensus?

I respect the market.

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3. **I often receive feedback and comments from people in the industry from all over the world. Many, many thanks. On Wednesday (July 10th) as the media headlines were proclaiming “equities are heading lower/doomsday” predictions, I received this note from Howard Felix, a financial advisor in the Chicago suburbs:**

Right now there are 307 new highs and 42 new lows in the U.S. stock market today. This is NOT what the beginning of a bear market looks like. The beginning of a problem may look like that the market is making new highs and there are only 38 stocks making new highs and 124 new lows. All the front line soldiers have been shot and there are a few generals and high end officers still in the battle. That is an unhealthy new high in the S and P. This, contrary to multiple stories out there, is not the case today!! All things change but predicting when they will change is a fools game.

Thank you Howard, I could not have said it any better!

4. **I am keenly aware that the three month period from mid-July until mid-October is seasonally the worst three months for the market.³**

Bad news pops up in the summer just as trading liquidity diminishes, a dangerous combination.

With the market up so strongly YTD, I think we could have some tough sledding near-term.

I think there is a decent chance the market will retest the 2,745 low on June 3rd sometime this summer.

My only hesitation is I am receiving far too many questions wondering “when is the pullback coming so I can get invested”. That indicates to me that there is plenty of cash out there....waiting. But as Doug Wiley (in another email comment) pointed out to me:

My experience is rarely does the market give you what you want when you want it.

In essence, how can we have a pullback with so many wanting one?

Having said that, near-term, I think it makes sense to at least tread carefully until we get through the summer. For Applied Equity Advisors, that means keeping an eye on our beta in an attempt to ensure the risk metrics in our portfolios are below those of the market.

5. **Nevertheless, I maintain my view that the market will be well north of 3,000 by year-end.**

I think the bears do not respect the current messaging of the market.

My time from 1991-2004 as a financial advisor taught me that there is really only one consistency to the investing world. **Human behavior.** Technology changes, economic cycles change, investment styles and products change, but how we react really never does.

Three of the most invaluable investment lessons I learned from my time as an FA were:

1. No investment philosophy/strategy works forever. Ultimately, each one fails when there are huge inflows of assets into them, producing the maximum amount of pain. Not before.
2. The fear-to-greed-to-fear cycle will never change, which is why being a financial advisor is as much psychiatry as it is financial expertise.
3. The markets can remain irrational longer than your clients' willingness to put up with a deeply intellectual, well-articulated, but nevertheless inaccurate viewpoint. An ACAT/closed account is a humbling reminder of what matters. Being right is more important than sounding smart.

As you know, it's because human behaviors chase what has worked and reject what has not that I am such a believer in a **style-flexible investment approach**. Let the market and human behavior dictate where the opportunities lie, rather than trying to predict. I always found managers who suggested that their investment approach was the path to constant success either unusually arrogant or belittling to their audience. Inevitably, they will be proven wrong just as they are put on the pedestal with the maximum asset flow.

Simply tacking against what is hot, leads headlong into the risk of #3. Said another way...there is a fine line between being “early” and just plain wrong. Being a contrarian always sounds more intellectually impressive. However, most of the time what works is **checking one's ego at the door**, while simply unemotionally **observing the market's signals**, and **positioning accordingly**.

But not always.

And there is the catch, which brings me to today.

Instead of taking my macro opinions and formulating a market outcome, (in fairness, that is what a strategist is asked to do) we can take the opportunity to interpret what the market is saying.

This leads me to the conclusions articulated at the beginning.

To reiterate:

The December equity market swoon predicted an economic slowdown in 2019. The equity market rally YTD is predicting an economic recovery to come. In essence, the weakening data has already been factored in.

I am not completely blind to the **recessionary signals**. **I just think they are premature:**

1. It is true that the 3 month-10 year yield curve inverted on March 22, 2019. And yield curve inversions have predicted every recession. But the yield curve has inverted **two years** ahead of the bull market top prior to the last four recessions (not to mention, the S&P 500 has tacked on another **40%** on average during this time).⁴
2. The New York Fed's Recessionary Predictor just crossed 33%, a level that has been a consistent predictor of a recession on the horizon. But here is the catch: **When?** Of the last 7 times it hit 33%, the S&P 500 was **up** 12.6% on average one year later.⁵

A recession in an election year? I agree with what Ed Yardeni said in Barron's recently:

My basic premise is that Trump wants to win another term and will avoid hurting the economy".⁶

A guest commentator on CNBC said it most appropriately:

I think the bears will find it very difficult to be short the market going into the second half of the year given you have the Fed delivering and you know Trump is going to have the economy humming going into an election year.⁷

I suspect that 2020 will be a strong year for the economy and earnings, and this is what the stock market is anticipating **now**. That will make for difficult comparisons in 2021, giving the market something to worry about next year!

Let me end with one valuable lesson I learned from being a financial advisor as it pertains to investing and behaviors. **I always paid attention to the types of products the asset managers were selling as they passed through our office.** Obviously, they would show us products they thought our clients would buy. I couldn't blame them, as that is how they get paid. My experience was that the longer a particular style/asset class or strategy worked, and therefore quite likely was nearing the end of its run, the higher the number of asset managers with similar products to capture that particular theme would visit our office.

Therefore, if there was a common product that I saw managers selling, it came with valuable investment messaging. How many tactical ("we regularly go to cash") strategies were introduced AFTER the 2008 bear market? *The worst thing to do after a bear market is to go to cash.* Do you remember everyone rolling out "dividend strategies" because we were in a "new normal" (low returns for stocks)? *The bull market trampled that idea.* Or what about MLP products rolled out in 2014 to capture the development of the domestic oil business....*before oil prices were obliterated in 2015.*

I see a common product today. "Quality/defensive strategies with good downside protection in case of a recession". Very popular, very crowded and **very expensive.**

To be clear, I do believe in protecting in bad markets. I am not against risk control.

But at the end of the day, I am a believer that the consistency of human behavior trumps all other predictors. If the overwhelming consensus today is caution, I refuse to believe that this time will be different, and the market is heading lower.

Simply put:

If there is a high level of conviction that we are late cycle...then we are not.

Andrew

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¹ Goldman Sachs: July 1st

² Evercore ISI Morning Economic Forecast. July 3rd, 2019

³ Since 1990, Morgan Stanley: Global Macro Forum, July 8th

⁴ Low beta does not guarantee outperformance in a down market

⁵ Factset, SentimentTrader: July 10th

⁶ Barrons, July 6th, 2019

⁷ CNBC, July 10th